No. 2580

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

J. W. RAPPLE,

Appellant,

vs.

HARRY A. DUTTON, as Trustee of the Estate of LENNIG ENGINEERING CO., Bankrupt,

Appellee.

APPELLANT'S REPLY BRIEF.

J. C. CAMPBELL, WEAVER, SHELTON & LEVY,
Attorneys for Appellant.

Filed this...............day of May, 1915.

FRANK D. MONCKTON, Clerk.

By...............Deputy Clerk.

Filed
MAY 29 1915
F. D. Monckton,
Clerk.

No. 2580

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

J. W. RAPPLE,
Appellant,
vs.
HARRY A. DUTTON, as Trustee of the Estate of LENNIG ENGINEERING CO., Bankrupt,
Appellee.

APPELLANT'S REPLY BRIEF.

Appellee's brief avoids the two principal points of appellant's argument; first, that the firm asset is *in custodia legis* and will be disposed of according to equity's rules of administration, and second, that since Rapple asserts a property right in the asset, the law of California as announced in *Conroy v. Woods* is controlling. Appellee adroitly substitutes a different issue—whether according to the weight of authority the agreement of the continuing partner on dissolution to pay the debts maintains the partner's equity in force, *eliminating the fact that the asset is in court.* Upon this substituted

issue appellee presents a convincing case; but it does not reach the real question to be decided here.

Thus appellee states our contention as follows:

> "Appellant bases his claim upon the retiring partner's lien or equity and argues that the right of a partner to require the application of the partnership property to the discharge of the partnership" (brief, p. 3).

In reply we point to the keynote of our argument: "The gist of this case is the retiring partner's equity invoked in respect to a firm asset *which is in the custody of the court*" (opening brief, p. 4). This is the basic factor which appellee has seen fit to ignore.

This subject—*custodia legis*—first appears in appellee's brief at page 8. The point of the statement there is far from clear. The impression is conveyed that we are asking the court to "interfere" with the contract of the parties here and that there is no occasion for marshalling of assets. Let us analyze the matter.

Clearly, this is a case where equity is called upon to administer the fund in court. If then, appellee's statement means that under the facts here equity will not marshal the former firm assets at the request of the retired partner so as to give to Rapple the benefit of Lennig's covenant to pay the debts and protect Rapple against loss while there remain firm assets available for the purpose, it is only necessary to say in reply that the *Filmar* and *Sargent* cases stand for this very proposition. And

far from "interfering" with the contract of the partners, equity will give effect to its purpose.

The quotation from the *Sargent* case at pages 8-9 of appellee's brief is erroneously arranged. The extract last quoted following the asterisks appears in the opinion at 160 Fed. 63 in the paragraph preceding that with which appellant introduces his quotation. And the latter is followed by the statement of the principle which appellee has failed to quote that the derivative right of firm creditors does not come into being until the asset is brought into court. The decision there does not concern the right of the retired partner. He was not a party. It was held merely that notwithstanding insolvency of the firm and its members, the continuing partner after dissolution and within four months prior to bankruptcy could with former firm assets pay an individual debt to one taking in good faith and the trustee could not recover them in a plenary action. The assets were not in court and *there was no occasion for applying the equitable rule of administration*. As the Court of Appeals said in meeting the contention of the trustee that assumption of the debts by the continuing partner on dissolution created a trust in favor of the partnership *creditors:*

> "It had no such effect at any time before the $3,731.90 was paid to Mrs. Sargent or before an application was made for the *interposition of a court to administer the partnership property.*"

The implication is plain that if the former firm asset had come into *custodia legis* after the dissolution and before transfer to a third person taking in good faith, the *creditors'* equity would have been available. And such was precisely the decision in the *Filmar* case where the situation was, as here, reinforced by the presence of the retired partner invoking his original equity. Thus did the court there distinguish the *Sargent* case. And the decision in *Case v. Beauregard,* presenting the same facts as in *Sargent v. Blake,* and upon which the result in the latter is based, is distinguishable in the same way.

Appellee devotes a short paragraph to an endeavor to avoid the force of the striking analogy in *Re Filmar.* He states that the claim there was "pressed by a partnership creditor who from the first refused to accept the continuing partner as a debtor" (p. 12). This is not urged as a ground of distinction but, lest it be so considered, we may point out that the creditor here is in the bankruptcy court, that it was the request by the retired partner that swept aside all objections to equitable administration in the *Filmar* case, and that if the Supply Co. here had accepted Lennig as its debtor, it would no longer have been a firm creditor and this controversy would not have arisen; in fact, as appears from the extract from the record, the defense of novation was raised in the suit against the partnership and must have been rejected.

Only one other suggestion is offered by appellee in this connection. He says:

> "The continuing partner was evidently insolvent at the time of dissolution of the copartnership, for within a few weeks thereafter he was adjudged a bankrupt and scheduled no property other than original partnership property and all of his debts were individual debts excepting that of the contesting creditor" (p. 12).

But appellee omits to mention that as the court said: "By payment and *novation* Filmar very shortly settled all partnership debts except one". The former firm creditors who were not paid thus became individual creditors of Filmar. It may be that he had no other creditors. It does not appear but that he used his personal funds to pay firm creditors. In the six weeks' period that elapsed he may have dissipated the firm assets concerning which the court said referring to the time of dissolution: "Partnership assets were then in excess of partnership debts". Thus, appellee's conclusion that Filmar was insolvent when the firm was dissolved is without support. It is a gratuitous assumption. Moreover, it is not likely that the decision of the Court of Appeals was based upon a fact which is not stated in its opinion, but must be deduced argumentatively from a collection of circumstances gathered at random. However, the court distinctly gives its reasons for deciding in favor of the retired partner (opening brief, p. 8); every one of them is present in the case at bar. And

finally, the immateriality of insolvency is plain from the *Sargent* case, where the firm and both members were insolvent and the creditors were denied relief (see Syllabus 1, by the court).

Appellee's statement (p. 12) that in *Loveland on Bankruptcy* the *Filmar* case is "distinguished from the general rule upon the ground of insolvency" is decidedly erroneous. The case is cited by Mr. Loveland in a footnote to the text quoted by appellee; no distinction whatever is pointed out—the statement is made as one of many instances when property is considered as a firm asset. Moreover, while the text may correctly state the law, the citation of *Re Filmar* in its support is an error. The text concerns the situation where a sale is made "by one partner to his copartner, when the firm is insolvent". In the *Filmar* case it is distinctly said that at the time of the sale by the outgoing partner "partnership assets were then in excess of partnership debts".

One word, before leaving this subject, concerning the quotation by appellee (p. 5) from *Remington on Bankruptcy*. The subject-matter of the section quoted from is the line of cases which we have just discussed. The author states before citing the *Sargent* case:

> "The assumption of payment of partnership debts by one partner in consideration of an absolute transfer to him of the partnership property by the other creates no trust in and fastens no lien upon the property thus transferred in favor of partnership *creditors* prior

> to any application to a court to interpose and assume administration of the property" (Sec. 2269, p. 2144).

There follows in the same section a discussion and extended quotation from the *Filmar* case.

We conclude from the foregoing that without regard to the situation of the firm creditor or even the retiring partner in a plenary proceeding where the former firm property is in the hands of a third person taking for value, it is established that when the asset is *in custodia legis* before the rights of innocent parties have intervened, the partner's equity must prevail. This principle has reached its full development in the bankruptcy courts, since the publication of the texts cited by appellee (pp. 5-8) in which it is not considered. And since these texts are concerned with the law of partnership alone, it is not surprising that the matter here in question is not discussed.

Appellee is thus clearly in error in drawing from his quotations which do not concern an asset *in custodia legis* the conclusion that the weight of authority is against our contention. Appellee has failed to produce a single precedent reaching the point involved here. The decisions of the courts of bankruptcy without exception confirm Rapple's right to require the fund in court to be administered as he requests.

But whether or not according to the weight of authority the covenant of the continuing partner to

pay firm debts preserves the retiring partner's lien, regardless of the other circumstances present here, such is the law of California and other states.

Appellee's attitude toward *Conroy v. Woods,* 13 Cal. 626, is not plain. At page 11 he quotes from *Bates on Partnership* concerning transfers between insolvent partners. Mr. Bates proceeds in his text to state the facts and conclusions in a case upon the subject; and in a note thereto the *Conroy* case is cited among many others. But an examination of the opinion in the *Conroy* case discloses no suggestion that either the firm or any member was was insolvent. The only mention of the subject was an averment that the sheriff who had levied upon the former firm asset was insolvent—made, no doubt, to bring the case within equitable jurisdiction and to obtain the injunctive relief desired. This was granted, however, without regard to the financial condition of the sheriff. In passing, it is notable that Mr. Bates' text is based upon precedents which are now obsolete. The contrary is directly decided in *Sargent v. Blake,* in consonance with the weight of authority (see Syllabus 6 and p. 65).

The sole ground of decision in *Conroy v. Woods* is quoted at page 5 of our opening brief. It determines squarely that under a dissolution such as the one involved here the firm property continued to be bound for firm debts. Appellee's indorsement of the statement of the Florida and Wisconsin

courts that the *Conroy* case is opposed to the weight of authority (brief, p. 10), is a tacit admission of the validity of our contention. For, as pointed out in the opening brief, Rapple's rights are to be determined according to the law of this state as evidenced by the decision of its highest court. Appellee has failed utterly to answer or even to mention this decisive feature of the case at bar.

It should be borne in mind that because of other facts in this case, appellant is not put to the necessity of relying upon the argument just outlined. An additional and independent reason is presented in support of the prayer for reversal.

Appellee has criticized our argument concerning the effect of Lennig's transfer to the corporation upon the ground that two inconsistent reasons are relied upon. Our contentions are, of course, cumulative; it is only upon the assumption for argument's sake that the corporate entity will be considered here at all that it becomes necessary to assert that the corporation took with notice. However, there is no inconsistency. Appellee says that the latter contention assumes, while the former denies, that the corporation is a legal entity. This is an error. Both concede *legal* entity; the first argument is that this factor will not prevent *equity* from protecting a property interest enforceable only in that forum by ignoring the corporate form which would, however, be conclusive in a court of law.

Appellee confesses: "We are not claiming that the corporation is a transferee without notice" (pp. 13-14). There is, then, no controversy. Rapple's equity is as effectual as if the asset were in the hands of Lennig. Appellee's suggestion that Lennig may have creditors who are not in court is not relevant; nor is the fact that the trustee here does not represent them. No rights of Rapple can be divested by the matter of the trustee's representation. The trustee, as well as the creditors of the corporation, stand in its shoes, and have no greater or better right, nor any equity which can undercut that of Rapple.

In reply to our other contention, appellee merely quotes from the well known case of *Salomon v. Salomon.* This decision does not in any way derogate from the federal authorities cited in our opening brief. The question before the House of Lords was simply whether or not Salomon had effected a legal incorporation of his company, so that the latter's creditors could not compel him to satisfy its debts. The circumstances leading up to the incorporation were thus stated by Lord Macnaghten:

> "Four of the sons were working with their father. The eldest, who was about thirty years of age, was practically the manager. But the sons were not partners: they were only servants. Not unnaturally, perhaps, they were dissatisfied with their position. They kept pressing their father to give them a share in the concern. 'They troubled me', says Mr. Salomon, 'all the while'. So at length Mr. Salomon did what hundreds of others have done under similar

> circumstances. He turned his business into a limited company. He wanted, he says, to extend the business and make provision for his family" (A. C. p. 49).

Difficulties were encountered—destructive trade conditions and labor troubles.

> "The attempts made to push the business on behalf of the new company crammed its warehouses with unsaleable stock. Mr. Salomon seems to have done what he could; both he and his wife lent the company money" (p. 49).

It was held:

> "But when once it is conceded that they (the other shareholders) were individual members of the company distinct from Salomon, and sufficiently so to bring into existence in conjunction with him a validly constituted corporation, I am unable to see how the facts to which I have just referred can affect the legal position of the company, or give it rights as against its members which it would not otherwise possess" (Lord Herschell at p. 43).

It was accordingly decided that the company could not, while insisting in court by prosecuting the action that it was a legal entity, compel Salomon to indemnify it against claims of creditors, subsequently created, on the theory that there was no *bona fide* incorporation.

> "The unpaid creditors of the company, whose unfortunate position has been attributed to the fraud of the appellant, if they had thought fit to avail themselves of the means of protecting their interests which the Act provides, could have informed themselves of the terms of pur-

> chase by the company, of the issue of debentures to the appellant, and of the amount of shares held by each member. In my opinion, the statute casts upon them the duty of making inquiry in regard to these matters" (Lord Watson at p. 40).

Here, on the contrary, is involved a property right existing prior to the incorporation. By organizing a company in which he alone was interested, and transferring to it the property in which his former partner's right inhered, Lennig could not destroy that right. If necessary to protect and enforce it, equity will view the case as if Lennig and his creditors were before the court. The creditors and their trustee standing in the place of the corporate bankrupt have no cause to complain.

A word, before concluding, concerning the fund in court. It is stipulated to be "profit"—meaning the excess of sale price over cost price or the balance remaining after the payment out of the contract price of the cost of materials and labor supplied by sub-contractors in performance. Thus it does not represent the value or price of the constituents of performance; else it would not be a profit. It was produced by the Guaranty Company in undertaking the completion of the contract for which it became responsible as the surety for the *partnership.* Therefore, appellee's effort to limit Rapple's equity to 40% of the fund should not prevail.

A few miscellaneous statements requiring a word in reply are made at pages 4-5 of appellee's brief. It is said that the Supply Company has not asked that the fund be used to pay its claim. But the courts have without exception held that the partner and not the creditor has the equity or lien invoked here. The creditor's claim is before the court; in the *Filmar* case the court observed that the fact that the partner had filed the petition disposed of all procedural objections.

Rapple's position is criticized because he has not offered to return the consideration paid him upon dissolution. But as the court in *Re Filmar* expressly points out, such was the case there. And there is no reason why Rapple should. The continuing partner made his own bargain and received full performance. His obligations were only partly carried out; there remains unperformed his covenant to pay the debts so that the retired partner will not be compelled to do so. Equity seizes the firm asset for this purpose; neither Lennig's creditors nor those of his corporation can complain. Thus the contract as made is enforced; Rapple is not seeking, as appellee asserts, to have a different contract made for him.

Dated, San Francisco,
May 29, 1915.

Respectfully submitted,

J. C. Campbell, Weaver, Shelton & Levy,
Attorneys for Appellant.